ASSEMBLY BILL 1115

New laws change method of tax computation

The laws guiding California's taxation of nonresidents, former nonresidents, and part-year residents are changing for taxable years beginning in 2002 as a result of California Assembly Bill 1115. The bill sets rules for calculating loss carryovers, deferred deductions, and deferred income.

The changes in the California taxation of income items as a result of AB 1115 need to be considered in determining your clients' estimated tax payments for taxable year 2002. Tax forms for 2002 will be revised to reflect the law changes.

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Assembly Bill 1115 amended Revenue and Taxation Code (R&TC) sections 17039, 17041, 17055, 17062, 17063, 17301, 17734, 17854, 17935, 17951, 17952, 17952.5, 17953, 17954, 17955, 23036 and 23453; created new sections 17015.5, 17301.3, 17301.4, 17301.5, 17304, 17306, 17307, 19322.1 and 19556; and repealed sections 17303, 17310 and 17554.

Section 1: The New Computation

Prorated Tax Computation:
Prior California law was silent on the tax treatment of loss carryovers, deferred deductions, and deferred income that vested prior to the time individuals became part-year or non-California residents. This new law changes the computation method to recognize those items. Beginning this year, your nonresident and part-year resident clients will determine their California tax by multiplying their California Taxable Income by an effective tax rate. The effective tax rate is the California tax on all income as if the person were a California resident for the current tax year and for all prior tax years for any carryover items, deferred income suspended losses, or suspended deductions, divided by that income.

The computation is as follows:

$$\text{California Taxable Income} \times \frac{\text{Tax on Total Taxable Income}}{\text{Total Taxable Income}} = \text{Prorated Tax}$$

How Are The Percentages Calculated?
Calculate percentages for California deductions, tax, and credits as follows.

To Calculate The Percentage For California	Instruction
Itemized or Standard Deductions	Divide the California AGI by the total adjusted gross income (not to exceed 1.0) ***<u>California AGI</u>*** ***Total AGI***
Tax Rate	Divide the tax on the total taxable income by the

	total taxable income. ***<u>Tax on Total Taxable Income</u>*** ***Total Taxable Income***
Credits	Divide the California taxable income by the total taxable income. ***<u>California Taxable Income</u>*** ***Total Taxable Income*** **Note:** This percentage does not apply to renter's credit, other state tax credit, or credits that are conditional upon a transaction occurring wholly within California.

California Taxable Income is California Adjusted Gross Income less California itemized or standard deductions.

California adjusted gross income is:

- Gross income and deductions derived from California sources for any part of the taxable year during which the taxpayer was a nonresident plus
- All items of gross income and all deductions regardless of source for any part of the taxable year during which the taxpayer was a resident. Any carryover items, deferred income, suspended losses or suspended deductions are included or allowable only to the extent they were derived from California sources for the period of nonresidency. Basis adjustments, including the basis in tax-free exchanges, for all prior years are determined under California law.

California Itemized or Standard Deductions are determined by applying the ratio of California AGI to Total AGI to all of the nonresident's or part-year resident's itemized deductions that are allowed to California residents. The ratio is limited to 1.00 so that the allowable California deductions do not exceed what was actually incurred by the nonresident or part-year resident.

Total Taxable Income is the entire taxable income of a nonresident or part-year resident determined:

- As if the nonresident or part-year resident were a California resident for the current taxable year; and
- As if the nonresident or part-year resident were a California resident for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

Credits:
Renter's credit, other state tax credit and credits that are conditioned upon a transaction occurring wholly within California (e.g., the Manufacturer's Investment Credit) are allowed in full. All other credits are prorated using the ratio of California Taxable Income over Total Taxable Income. For prorated credits, the ratio is not limited to 1.00. However, the actual prorated credit amount cannot exceed the specific dollar limit applicable to the credit.

Example 1-1: Tom lived in Washington until March 31, 2002. He became a California resident on April 1, 2002. Tom earned and received wages of $15,000 in Washington while he was a Washington resident, and he earned wages of $65,000 while he was a California resident. Tom also earned $4,000 in interest income during 2002, $1,000 while a resident of Washington and $3,000 while a California resident.

Tom is single and had the following itemized deductions in 2002:

Real estate taxes:	$ 1,200 (CA house)
	800 (WA house)
Mortgage interest:	17,000 (CA house)
	3,500 (WA house)
Charitable contributions:	1,500 (NY Firefighters' Fund)
	$24,000

Calculation of Tom's 2002 California Tax Liability:

CA AGI:	$65,000 (CA wages)
	+ 3,000 (Interest earned while a CA resident)
	$68,000
Total AGI:	$80,000 (Wages from all sources)
	+ 4,000 (Interest income from all sources)
	$84,000
CA Itemized Deductions:	24,000 (Total itemized deductions)
	x .8095 (CA AGI ÷ Total AGI)
	$19,428
CA Taxable Income:	$68,000 (CA AGI)
	- 19,428 (CA itemized deductions)
	$48,572
Total Taxable Income (TI):	$84,000 (Total AGI)
	- 24,000 (Total itemized deductions)
	$60,000
Tax on Total Taxable Income:	$ 3,733 (Tax table*)
Prorated Tax:	$48,572 (CA Taxable Income)
	x .0622 (Tax on Total TI ÷ Total TI)
	$ 3,021
ΘΘ Prorated Exemption Credit:	$ 79 (Personal exemption credit*)
	x .8095 (CA Taxable Income ÷ Total TI)
	$ 64
Tax Liability:	$ 3,021 (Prorated tax)
	- 64 (Prorated exemption credit)
	$ 2,957

* For purposes of this example, the 2001 Tax Table and personal exemption credit amounts have been used.

**Even though, under Assembly Bill 1115, the proration of personal exemption credits was not really changed, since exemption credits are figured after the prorated tax, the new computation makes the proration more explicit.

Once Tom, the taxpayer in Example 1-1, becomes a California resident, he will pay taxes on all income, regardless of source. In addition, AB 1115 provides that Tom should treat carryover items, suspended losses, etc., as if he were a California resident in the current year and all prior years. If Tom decides to move out of California in the future, he will pay taxes on a source basis and calculate his carryover items accordingly.

Section 2: Installment Sales

Assembly Bill 1115 repealed Revenue and Taxation Code section 17554, pertaining to income accrual. Beginning this year, California taxes installment gains received by a nonresident from the sale of tangible property on a source basis. Real property is taxed based upon where the property is located. Installment gains from the sale of intangible property are generally sourced to the recipient's state of residence. Residents are taxed on all income regardless of source.

For those who were always nonresidents
The repeal of section 17554 does not change the taxation of California property installment proceeds for nonresidents who have always been nonresidents. California taxes the installment proceeds received by a nonresident to the extent the income from the sale was from a California source.

Example 2-1: Bob is a nonresident of California. On March 1, 2001, he sold a California rental property in an installment sale. During 2001 and 2002, Bob received installment proceeds comprised of capital gain income and interest income. California taxes the capital gain income in both 2001, and 2002, because the property was located in California. California does not tax the interest income, which has a source in Bob's state of residence.

Example 2-2: Jane is a nonresident of California. On June 4, 2001, she sold a parcel of land located in Idaho on an installment basis. California does not tax the gain on the sale or any of the installment proceeds while Jane is a nonresident because the source of the gain is Idaho.

For former California residents
The repeal of section 17554 may reduce taxes for some former California residents. They will no longer be taxed on installment proceeds received from the sale of property located outside California that was sold while the taxpayer was a resident.

Example 2-3: In June 1999, Jim, while a California resident, sold a parcel of real property located in Washington in an installment sale. On March 1, 2002, Jim became an Ohio resident and on June 1, 2002, he received installment proceeds comprised of capital gain income and interest income. California does not tax Jim's capital gain income received on June 1, 2002, because the property was not located in California. California also does not tax the interest income because Jim was a nonresident of California when he received the proceeds.

For California residents who were formerly nonresidents
Residents are taxed on all income regardless of source. With the repeal of section 17554, California now taxes installment proceeds received by a resident from the sale of property located outside California that was sold before the taxpayer became a California resident.

Example 2-4: On July 1, 2001, Sue, while a nonresident of California, sold her Texas rental property in an installment sale. On May 15, 2002, Sue became a California resident and on August 1, 2002, she received installment proceeds. California taxes Sue's installment proceeds received on August 1, 2002, because she was a California resident when she received the proceeds.

Example 2-5: On September 1, 2000, Sandra, while a nonresident of California, sold stock (intangible property) in an installment sale. On June 1, 2002, Sandra became a California resident and on October 1, 2002, she received installment proceeds from the stock sale. California taxes Sandra's installment proceeds received on October 1, 2002, because she was a California resident when she received the proceeds.

Section 3: Individual Retirement Accounts (IRAs)

Assembly Bill 1115 sets rules for calculating deferred income. The new laws do not affect the taxation of IRA income, income from employer sponsored retirement plans, and compensation income of a nonresident, whether the nonresident was always a nonresident or was formerly a California resident. However, they do affect California residents who were formerly nonresidents.

For Nonresidents

Compensation received by a nonresident for performance of services is taxed on a source basis. If the services are performed in California, the compensation income is sourced to California. California does not tax the IRA distributions, qualified pension, profit sharing, and stock bonus plans of a nonresident.

Example 3-1: David, a nonresident of California, lives and works in Wyoming. David's Wyoming firm temporarily assigned him to California for four months to complete a project. David continues to receive his paycheck from his employer's Wyoming headquarters. David earns $5,000 per month. California taxes $20,000 ($5,000 x 4) as compensation for services having a source in California, the state where David performed four months of his services.

For California residents who were formerly nonresidents

Beginning this year, a former nonresident no longer receives a stepped-up basis for annual contributions and earnings in an Individual Retirement Account (IRA) simply because the individual was a nonresident when the contributions were made.

The new laws treat a former nonresident as though the taxpayer were a resident for all prior years for all items of deferred income, which includes IRAs. Accordingly, a former nonresident will be allowed a basis for contributions which would not have been allowed under California law had the taxpayer been a California resident.

California did not conform to the $2,000 or 100% of compensation annual contribution limit permitted under federal law from 1982 through 1986. During these years, California limited the deduction to the lesser of 15% of compensation or $1,500 and denied a deduction altogether to individuals who were active participants in qualified or government plans. Any amounts an individual contributed in excess of California deduction limits during these years create a basis in the IRA.

Example 3-2: Mary became a California resident on January 1, 2001. The fair market value of her IRA on January 1, 2001, was $9,000. Her contributions in excess of California deduction limits during 1982-1986 were $2,500. Mary received IRA distributions of $1,500 in 2001, and $3,000 in 2002.

Tax Year 2001 (pre-AB 1115):	
California IRA basis, 1/1/01	$9,000 (Fair market value on 1/1/01)
Less: IRA distribution	$1,500
California IRA basis 12/31/01	$7,500
Tax Year 2002 (post-AB 1115):	

IRA distribution, 2002	$3,000
Less: California IRA basis	
Contributions in excess of California deduction limits	$2,500
Less: California IRA basis recovered in 2001	1,500
California IRA basis available in 2002	1,000
Taxable IRA income	$2,000

Section 4: Employer Sponsored Retirement Plans

California taxes qualified pension, profit sharing, and stock bonus plan income received by a resident for services performed outside California while the taxpayer was a nonresident.

Example 4-1: Rick permanently moved from Florida to California on January 1, 2002. He received pension income during 2002 through a qualified plan from his former Florida employer. California taxes Rick's qualified pension income because he was a California resident when he received the income.

Section 5: Compensation

Residents are taxed on all income regardless of source. With the repeal of Revenue and Taxation Code section 17554, California now taxes compensation received by a resident that accrued before the taxpayer became a California resident.

Example 5-1: Jill lived and worked in New York until April 30, 2002. She permanently moved to California on May 1, 2002. Her former New York employer pays its employees on the 5th of every month. On May 8, 2002, Jill received her last paycheck of $3,000 in the mail from her former New York employer. California taxes the compensation of $3,000 because Jill was a California resident when she received the income. If Jill also paid tax to New York on this compensation, she is allowed a credit for taxes paid.

Section 6: Stock Options

Assembly Bill 1115 does not affect taxation of employee stock options.

Nonresidents

California taxes the wage income received by a nonresident from employee stock options on a source basis, whether the nonresident was always a nonresident or was formerly a California resident.

Example 6-1: On February 1, 1999, while a California resident, John's company granted nonstatutory stock options to him. John performed all of his services in California from February 1, 1999 to May 1, 2002, the date John left the company and permanently moved to Texas. On June 1, 2002, John exercised his nonstatutory stock options. California taxes the income resulting from the exercise of the nonstatutory stock as compensation for services having a source in California, the state where John performed all of his services.

For California residents who were formerly nonresidents

California taxes the wage income received by a former nonresident from employee stock options because all the income is recognized while the taxpayer is a California resident.

Example 6-2: On March 1, 1998, while a Nevada resident, Fred was granted nonstatutory stock options. On April 1, 2002, he retired and permanently moved to California. On May 1, 2002, Fred exercised his

options. California taxes Fred's compensation resulting from the exercise of his nonstatutory stock options because Fred was a California resident when the income was recognized.
California also taxes the capital gain income received by a former nonresident from the sale of stock in a qualifying disposition of statutory stock options because the stock is sold while the taxpayer is a resident.

Example 6-3: On February 1, 1998, while a Texas resident, Nancy was granted incentive stock options. On February 1, 2001, she exercised her options. On December 1, 2001, Nancy permanently moved to California and sold her stock on March 1, 2002, for a gain. California taxes the resulting capital gain because Nancy was a California resident when she sold the stock.

Get FTB Publication 1004, Stock Option Guidelines, for additional information on the California taxation of stock options.

Section 7: Deferred Gains (Section 1031 Exchanges)

Gain from the sale or exchange of real or tangible personal property located in this state is sourced to California at the time the gain is realized.[1]

If a nonresident taxpayer exchanges property located within California for property located outside California, the realized gain will be sourced to California, although tax will not be assessed until the gain is recognized. This requires nonresidents to keep track of their deferred gains sourced to California so that they can be reported to California in the year the gain is recognized.[2]

If out-of-state real property or tangible personal property is exchanged for real property or tangible personal property located within California and all the requirements under Internal Revenue Code section 1031 have been met, when the California property is disposed of (assuming it is not disposed of in another deferred gain transaction), the gain will be sourced to California.

California property exchanged for out-of-state property
Example 7-1: Jim, a resident of Texas, owned a condominium in California. Jim exchanged the condominium for like-kind property located in Texas. There was no boot on the exchange that met all of the requirements for Internal Revenue Code section 1031 treatment. Jim realized a gain of $15,000 on the exchange. Jim must recognize the lesser of the deferred gain of $15,000 or the gain recognized at the time Jim disposes of the Texas property, assuming he does so in a non-deferred transaction.

Out-of-state property exchanged for California property
Example 7-2: Jane was a resident of Nevada when she exchanged Nevada business property for like-kind California business property. Jane realized a $10,000 gain on the property that was properly deferred under Internal Revenue Code section 1031. Jane then sells the California property while still a resident of Nevada. Jane recognizes $50,000 of gain in a non-deferred transaction. Because the property is located in California, the $50,000 gain is sourced to California.

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[1] See California Code of Administration, Title 18, Regulation 17951-3. *Gains from the sale of intangible property are generally sourced to the recipient's state of residence*.

[2] It should be noted that gain from the sale of a principal residence after May 7, 1997, is no longer deferred. Rather, the law provides for an exclusion of gain up to a certain dollar limitation. The non-excluded portion of the gain will be taxable to California for a nonresident if the residence was located in California. Residents are taxed on the gain regardless of the location of the principal residence.

Example 7-3: John is a resident of Kansas when he exchanges property located in Kansas with property located in California in a transaction that qualifies for Internal Revenue Code section 1031 treatment. There is no boot on the transaction and John realizes $12,000 of gain. John becomes a resident of California and, while a California resident, he disposes of the California property in a non-deferred transaction. All of the gain recognized will be taxed by California because John is a resident at the time of the sale. If Kansas taxes a portion of the recognized gain because of the deferral of gain associated with the Kansas property, John may be able to take an Other State Tax Credit.

Section 8: Capital Gains and Losses

Capital loss carryovers and capital loss limitations for nonresidents are determined based upon California source income and loss items only for computation of California Taxable Income.

Example 8-1: Mary, a resident of Oregon, has a $4,000 capital gain sourced to California, a $2,000 capital loss sourced to California, a $1,000 capital gain sourced to Oregon and a $5,000 capital loss sourced to Oregon. For determining California Taxable Income, Mary will net her California capital gains and losses. Mary has a $2,000 net capital gain that is included in her California Taxable Income.

Example 8-1	Total Taxable Income	California Taxable Income
CA Capital Gain	$4,000	$4,000
CA Capital Loss	(2,000)	(2,000)
OR Capital Gain	1,000	
OR Capital Loss	(5,000)	
Total	$(2,000)	$2,000

Example 8-2
2002 - Nonresident
In 2002, Mike, a New York resident, has a $2,000 capital gain sourced to California, a $6,000 capital loss sourced to California, a $5,000 capital gain sourced to New York and a $2,000 capital loss sourced to New York. For determining California Taxable Income, Mike will net his California sourced capital gains and losses. Mike will have a net capital loss of $4,000. He can take $3,000 of that loss this year and carryforward $1,000 to 2003.

Example 8-2 - 2002	Total Taxable Income	California Taxable Income
CA Capital Gain	$2,000	$2,000
CA Capital Loss	(6,000)	(6,000)
NY Capital Gain	5,000	
NY Capital Loss	(2,000)	
Total	$(1,000)	$(4,000)
Loss Used in 2002		3,000
Carryover		$(1,000)

2003 - Resident
Assume Mike became a California resident beginning January 1, 2003. Mike's capital loss carryforward needs to be restated as if he had been a resident for all prior years. Assuming that Mike had no other capital gains or losses prior to 2002, Mike would have no capital loss carryforward into 2003 because he

had a net capital loss of $1,000 for 2002, computed as if he was a resident for that year, which is within the $3,000 limitation.

During 2003, Mike has a $5,000 capital gain from the sale of property located in another state and a $4,000 capital loss from property located in California. As a resident of California, Mike will net his gain and loss for a net $1,000 capital gain. If Mike had been a nonresident, he would have had a $4,000 capital loss sourced to California. He would have taken $3,000 of that amount and would have carried forward $1,000.

Example 8-2 - 2003	California Taxable Income
Capital Gain	$5,000
Capital Loss	(4,000)
Total	$1,000

As a resident, the source of the items does not matter because all income is taxed. If Mike had been a nonresident, only the $4,000 capital loss would have been sourced to California.

2004 - Nonresident
Assume that on January 1, 2004, Mike becomes a nonresident again. He restates his carryforwards taking into account items of gain and loss sourced to California. On a source basis, Mike had a $1,000 capital loss carryforward from 2002. In 2003, he had a $4,000 capital loss carryforward. He would have been allowed to use $3,000 of that loss in 2003 and would have carried forward $1,000 from 2003 and $1,000 from 2002 into 2004.

Example 8-2 -2004	Capital Loss Carryover
Carryover from 2002	$1,000
Carryover from 2003	1,000
Total carryover to 2004	$2,000

Characterization of Gains and Losses
The character of gains or losses on the sale or exchange of property used in a trade or business or certain involuntary conversions (Internal Revenue Code section 1231 gains and losses) are determined for purposes of calculating California Taxable Income by netting California sourced section 1231 gains and losses only.

Example 8-3: Peter, a resident of Washington, has a $3,000 section 1231 gain sourced to California, a $2,000 section 1231 loss sourced to California, a $4,000 section 1231 gain sourced to Washington and a $5,000 section 1231 loss sourced to Washington. For determining California Taxable Income, Peter will net his $3,000 gain and his $2,000 loss for a $1,000 net section 1231 gain sourced to California. This gain will be a capital gain.

Example 8-3	Total Taxable Income	California Taxable Income
CA §1231 Gain	$3,000	$3,000
CA §1231 Loss	(2,000)	(2,000)
WA §1231 Gain	4,000	
WA §1231 Loss	(5,000)	
Total	$0	$1,000

Example 8-4: Paula, a resident of Florida, has a $2,500 section 1231 gain sourced to California, a $3,000 section 1231 loss sourced to California, a $1,000 section 1231 gain sourced to Florida and a $500 section 1231 loss sourced to Florida. For determining California Taxable Income, Paula will net her $2,500 gain and her $3,000 loss for a $500 net section 1231 loss. This loss will be ordinary.

Example 8-4	Total Taxable Income	California Taxable Income
CA §1231 Gain	$2,500	$2,500
CA §1231 Loss	(3,000)	(3,000)
FL §1231 Gain	1,000	
FL §1231 Loss	(500)	
Total	$0	$(500)

Section 9: Suspended Gains and Losses

For those who were always nonresidents

For the computation of California Taxable Income of nonresidents, the amount of passive activity losses allowed and the amount that is suspended are determined based only upon California source passive income and loss items.[3] Only the California source passive losses carry forward into the subsequent year.

Example 9-1: Charles, a resident of Arizona, owns three rental properties. Properties A and B are located in Arizona, and Property C is located in California. In 2002, the Arizona rental property activities resulted in net income of $1,000 for Property A and $4,000 for Property B. Property C incurred a $26,000 net loss.

In determining Charles' California Taxable Income, his gross income and deductions may only include those items derived from sources within this state.[4]

Example 9-1A - 2002	**Total Taxable Income**	**Total Suspended Losses to 2003**	**California Taxable Income**	**California Suspended Losses to 2003**
AZ Property A	$ 1,000	–	–	–
AZ Property B	4,000	–	–	–
CA Property C	(26,000)	–	($26,000)	($1,000)**
Suspended Loss to 2003	-	-	1,000	
Total	($21,000)*	–	($25,000) *	($1,000)**

* Internal Revenue Code section 469 (i) $25,000 passive activity loss offset
**($26,000) + $25,000 (passive activity loss offset) = ($1,000) carryforward

3 For aggregation purposes, only those activities with a California source may be aggregated.
4 Revenue and Taxation Code section 17041(i)(1)(B).

All of Charles' passive losses have been allowed for federal purposes. But since only California sourced items are considered for California Taxable Income, Charles exceeded the $25,000 passive activity loss offset and must carry forward the $1,000 remaining loss for California purposes.

Assume in 2003, Property A has a $2,000 loss, Property B has a $1,000 loss and Property C has $2,000 of net income**.**

Example 9-1B – 2003	**Total Taxable Income**	**Total Suspended Losses to 2004**	**California Taxable Income**	**California Suspended Losses to 2004**
AZ Property A	($2,000)	–	–	–
AZ Property B	(1,000)	–	–	–
CA Property C	2,000	–	$2,000	–
Prior Year Suspended Loss Allowed	–	–	(1,000)	–
Total	($ 1,000)	=	$1,000	=

Even though Charles has a loss for federal purposes, he has a gain on his California sourced property. For California purposes, in 2003 Charles may use his $1,000 in suspended losses from 2002 against the net income of his California property.

Example 9-2: Sierra, a resident of New York, owns rental property located in California, is a member of a Limited Liability Company doing business exclusively within California that elected to be taxed as a partnership, and is a shareholder of an S Corporation doing business solely within Texas. In 2002, Sierra's rental property had a $2,000 loss, her share of the Limited Liability Company losses was $5,000 and her share of the S Corporation income was $1,000.

Example 9-2 - 2002	**Total Taxable Income**	**Total Suspended Losses to 2003**	**California Taxable Income**	**California Suspended Losses to 2003**
CA Rental Property	($2,000)	-	($2,000)	
CA Limited Liability Company	(5,000)	($4,000)	(5,000)	($5,000)
Texas S Corporation	1,000	–	–	–
Suspended Loss to 2003	4,000		5,000	
Total	($2,000)	($4,000)	($2,000)	($5,000)

Sierra is allowed to take the full $2,000 loss on the rental property under the special real estate allowance.[5] She may, however, only take her other losses to the extent that they are offset by gains. For California Taxable Income purposes, Sierra may not offset the LLC losses against the Subchapter S Corporation income because the S Corporation income is sourced to Texas, not California. Therefore, she will carry forward the entire $5,000 loss. For federal purposes, Sierra will offset the Texas S corporation income with $1,000 of the LLC loss and carry forward the remaining $4,000.

[5] Internal Revenue and Taxation Code section 469(i).

For California residents who were formerly nonresidents
When a nonresident becomes a resident, all prior year items are restated as if the taxpayer had been a California resident for all prior years.

Example 9-3: Assume Sierra becomes a California resident on January 1, 2003. When Sierra becomes a resident, she restates her carryovers into 2003 as if she had always been a resident. Had she been a resident in 2002, she would have been able to offset her Texas S corporation income and she would have had only $4,000 of loss to carry forward. Therefore, her suspended loss carryover from 2002 to 2003 as a resident is $4,000.

Section 10: Net Operating Losses and Deductions:

The net operating loss (NOL) deduction allowed in computing the California Taxable Income of a nonresident or part-year resident for the portion of the year the part-year resident is a nonresident is no longer limited by the amount of net operating loss from all sources.

For those who were always nonresidents
Starting January 1, 2002, a nonresident is allowed a net operating loss deduction for California Taxable Income purposes based upon sourced income and deductions, regardless of whether he or she has a net operating loss in computing Total Taxable Income.

Example 10-1: Kim is a resident of Texas and operates two businesses – one conducts business wholly within California and the other wholly without California.[6] In 2001 and 2002, Kim's businesses produced the following results:

Example 10-1A 2001	**Total Taxable Income**	**California Taxable Income**
Texas Business	$ 7,000	
California Business	(2,000)	(2,000)
Total	$ 5,000	(2,000)
Example 10-1B 2002	**Total Taxable Income**	**California Taxable Income**
Texas Business	$ 9,000	
California Business	(3,000)	(3,000)
Total	$ 6,000	(3,000)

For years prior to 2002, California law did not allow Kim a NOL carryover for California Taxable Income purposes because Kim did not have a NOL carryover from all sources. Kim is not able to utilize the $2,000 loss from 2001 for California purposes in future years.

[6] The two businesses are not unitary.

Beginning January 1, 2002, only California sourced items are considered in determining if a taxpayer has a California NOL. For 2002, Kim has a California NOL of $3,000. Kim may carryover 60% of the $3,000 NOL, or $1,800, to 2003 to offset her California Source Income.

For California residents who were formerly nonresidents

When a nonresident becomes a resident, all prior year items are restated as if the taxpayer had been a California resident for all prior years.

Example 10-2: Nick moves to California on January 1, 2002. Prior to 2002, Nick incurred $2,000 in NOL carryovers from his Nevada business under California law. In 2002, Nick incurs a $3,000 loss from his California business and income of $1,000 from his Nevada business. For California purposes, Nick has a current year carryover loss of $1,200 and may carryover $3,200 to future years.

Example 10-2 2002	**Total Taxable Income**
Nevada Business	$1,000
California Business	(3,000)
Total	($2,000)
	X 60%
Net Operating Loss, 2002	($1,200)
Prior Year NOL Carryover	(2,000)
Net Operating Loss Carryover to 2003	($3,200)

Example 10-3 – Assume the same facts as Example 10-2, but Nick moves back to Nevada on January 1, 2003 and is full year nonresident. In 2003, Nick's Nevada business incurs income of $5,000 and his California business incurs income of $4,000.

To compute his 2003 California Taxable Income, Nick restates his 2002 NOLs as if he had been a nonresident for all prior years. Nick has a net operating loss carryover to tax year 2003 of $1,800.

Example 10-3 2002 **(As if Nonresident)**	**Total Taxable Income**	**California Taxable Income**
Nevada Business	$1,000	
California Business	(3,000)	($3,000)
Total	($2,000)	($3,000)
	X 60%	X 60%
Net Operating Loss, 2002	($1,200)	($1,800)
Prior Year NOL Carryover	(2,000)	
NOL Carryover to 2003	($3,200)	($1,800)

Example 10-3 2003 **Nonresident**	**Total Taxable Income**	**California Taxable Income**
Nevada Business	$5,000	
California Business	4,000	$4,000
Total	$9,000	$4,000
NOL Carryover from 2002	(3,200)	(1,800)
Total	$5,800	$2,200

Section 11: Basis in Pass-Through Entities

A taxpayer-owner's basis in a pass-through entity[7] for California purposes is equal to his or her contributions to capital, adjusted (as required under California law) by California sourced items only.

For those who were always nonresidents

Example 11-1: Brandi, a resident of Nevada, invests $10,000 in Partnership Z. Brandi is a 50% partner. At the close of the year, the partnership had generated a $4,000 loss, 30%, or $1,200, of which is sourced to California. Brandi's share of the California loss is 50%, or $600.[8] Brandi's adjusted basis in Partnership Z as of December 31, 2002 is $9,400; her initial investment of $10,000 less the $600 distributive share.[9]

For California residents who were formerly nonresidents

When a nonresident owner becomes a resident of California, his or her basis in the pass-through entity is restated under California law as if the former nonresident had been a resident for all prior periods. Basis is adjusted for his or her share of flow through items, regardless of source, generated during periods of nonresidency.

Example 11-2: Brandi, from Example 11-1, becomes a resident of California on January 1, 2003. Brandi's basis as of December 31, 2002, would be restated to include all adjustments, regardless of source. Her initial investment is reduced by $2,000 – 50% of the $4,000 loss incurred by the partnership. Her adjusted basis as of January 1, 2003 is $8,000.

Section 12: Alternative Minimum Tax

Assembly Bill 1115 changed the Alternative Minimum Tax computation for nonresidents and part-year residents to parallel the changes in the regular tax computation.

The **California Alternative Minimum Tax** of a nonresident or part-year resident is the amount by which the California tentative minimum tax exceeds the prorated regular tax.

[7] Pass-through entities include partnerships, S corporations and LLCs that elect to be treated as partnerships. The term "owner" is used here to refer to a partner, shareholder or member of a pass-through entity.

[8] See Regulation 17951-4(d) regarding sourcing of distributive shares of a multistate partnership.

[9] This California adjusted basis is used for determining loss limitations while Brandi is a nonresident. If Brandi sells her partnership interest while she is a nonresident, the gain or loss on the sale would not be sourced to California, unless her partnership interest had a business situs in California. (*Appeal of Ames et al.*, 87-SBE-042, June 17, 1987.)

California Alternative Minimum Tax	=	California Tentative Minimum Tax	—	Prorated regular tax

The California Tentative Minimum Tax **is the California alternative minimum taxable income multiplied by a rate. The rate is the amount of tax on total tentative minimum tax divided by the total alternative minimum taxable income. The computation is as follows:**

California Tentative Minimum Tax	=	California Alternative Minimum Taxable Income	x	Total Tentative Minimum Tax Total Alternative Minimum Taxable Income

The **California Alternative Minimum Taxable Income** is:

The alternative minimum taxable income derived from California sources for any part of the taxable year that the taxpayer was a nonresident *plus*
The alternative minimum taxable income from all sources for any part of the taxable year that the taxpayer was a resident.

For the period of nonresidency, any carryovers, deferred income, suspended losses, or suspended deductions are included or allowable only to the extent they were derived from California sources.

The **Total Alternative Minimum Taxable Income** is the alternative minimum taxable income determined as if the nonresident or part-year resident were a California resident in the:

Current year; and in

All prior years for any carryovers, deferred income, suspended losses, or suspended deductions.

Total Tentative Minimum Tax is the tax on the total alternative minimum tax income.

Example 12-1: The following example illustrates the computation of the alternative minimum tax.

Rick and Rita moved to California and became residents on May 1, 2002. Rick and Rita had $170,000 in combined wages for the year. They received $100,000 after their move to California. On October 1, 2002, Rita exercised an incentive stock option valued at $90,000 for which she paid $10,000 (preference amount $80,000). The total taxable income for the year was $150,000. The total itemized deductions for the year was $20,000. Five thousand ($5,000) of the itemized deductions are real and personal property taxes, which are preferences items. Their prorated regular tax was $6,035.

Calculation of Rick and Rita's 2002 California Alternative Minimum Tax:

Total Alternative Minimum Taxable Income

Real and personal property tax preference ……………………………………..	5,000
Plus: Incentive stock option preference …………………………………………	+ 80,000
Plus: Total taxable income ………………………………………………….….	+150,000

Total Alternative Minimum Taxable Income…..…………………………………		**235,000**
Total Tentative Minimum Tax		
Total Alternative Minimum Taxable Income…………………………………..		235,000
Less: Exemption amount * ……………………………………………………		- 64,152
		170,848
Alternative Minimum Tax rate …………………………………………………….		x .07
Total Tentative Minimum Tax ……………………………………..………...		**11,959**
California Alternative Minimum Tax Adjusted Gross Income		
California (regular tax) adjusted gross income …………………………………		100,000
Plus: Incentive stock option preference amount ………………………………		+ 80,000
California Alternative Minimum Tax Adjusted Gross Income………..………..		**180,000**
Total Alternative Minimum Tax Adjusted Gross Income		
Total Alternative Minimum Taxable Income…………………………………..		235,000
Total itemized deductions……………………………………………………….	20,000	
Less: Real and personal property tax preference…………………………...	- 5,000	
Total Alternative Minimum Tax Itemized Deductions ………………………….		+ 15,000
Total Alternative Minimum Tax Adjusted Gross Income……………………….		**250,000**
California Alternative Minimum Taxable Income		
Total Alternative Minimum Tax Itemized Deductions ………………………...	15,000	
Multiple by the ratio: California Alternative Minimum Tax Adjusted Gross Income 180,000 = Total Alternative Minimum Tax Adjusted Gross Income 250,000	x .7200	
Prorated alternative minimum tax itemized deductions ……………………..…		- 10,800
California Alternative Minimum Taxable Income ……………………………....		**169,200**
California Alternative Minimum Tax		
California Alternative Minimum Taxable Income………………………………..		169,200

Multiple by the ratio:	
Total Tentative Minimum Tax 11,959 = / Total Alternative Minimum Taxable Income 235,000	x .0509
California Tentative Minimum Taxable Income …………………………………	8,612
Less: Prorated regular tax ………………………………..……………………	- 6,035
California Alternative Minimum Tax……………………………………………	**2,577**

* For purposes of Example 12-1, the 2001 exemption amount was used.

TO CALCULATE THE PERCENTAGE FOR CALIFORNIA	INSTRUCTION
AMT Tax Rate	Divide the total tentative minimum tax by the total alternative minimum taxable income. **Total Tentative Minimum Tax** **Total Alternative Minimum Taxable Income**
AMT Itemized Deductions	Divide the California alternative minimum tax adjusted gross income by the total alternative minimum tax adjusted gross income. California Alternative Minimum Tax AGI **Total Alternative Minimum Tax AGI**

Credit Ordering – Credit for Prior Year Alternative Minimum Tax

Assembly Bill 1115 clarifies that the Credit for Prior Year Alternative Minimum Tax is applied **before** any credit that can reduce regular tax below the tentative minimum tax.[2] Prior to this change, taxpayers were allowed to claim credits that can reduce regular tax below tentative minimum tax before and after the application of the Credit for Prior Year Alternative Minimum Tax. This change resolves conflicting provisions in the law over whether the Credit for Prior Year Alternative Minimum Tax should be applied before or after credits that can reduce regular tax below the tentative minimum tax.

The Franchise Tax Board is preparing a new publication to provide additional guidance and examples. Please watch for *Publication 1100 – Guidelines of Nonresidents and Individuals Who Change Residency*. If you or your client changed residency, it is especially important that you request this Publication. Since part-year residents are taxed as residents for that period during which they were residents and as nonresidents for the remaining period, part-year residents are subject to a combination of the rules set forth in this article. The Publication will have examples illustrating the application of AB 1115 to the part-year resident.

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[2] Personal Income Tax – R&TC § 17039(a), 17039(c) and 17063(c)
Bank and Corporation Tax - R&TC § 23036(c), 23036(d) and 23453